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No. 94-18 (9)

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

ANTONIO C. MASTROBUONO and
DIANA G. MASTROBUONO,
Petitioners,

v.

SHEARSON LEHMAN HUTTON INC.,
a corporation, and NICK DIMINICO,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF RESPONDENTS

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QUESTIONS PRESENTED

Whether the court of appeals correctly interpreted the arbitration agreement at issue in this case as precluding the arbitrators from awarding punitive damages.

Whether the court of appeals correctly interpreted the arbitration agreement at issue in this case as precluding petitioners from asserting an independent "claim" for punitive damages in court.

LIST OF PARTIES

Petitioners:

Antonio C. Mastrobuono

Diana G. Mastrobuono

Respondents:

Lehman Brothers Inc. (Lehman Brothers Inc. is the successor corporation to the corporation that was formerly known as Shearson Lehman Hutton Inc.).

Nick DiMinico

Richard F. Benzer and Mark Stevenson were not appellees in the court below and are not parties herein

The following is furnished in compliance with Supreme Court Rule 29.1:

Lehman Brothers Inc.
Parent Company — Lehman Brothers Holdings Inc.
Subsidiaries (except wholly owned) — None

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IN THE
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OCTOBER TERM, 1994

No. 94-18

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

v.

SHEARSON LEHMAN HUTTON INC., ET AL.

On Writ of Certiorari to the United
States Court of Appeals for the Seventh Circuit

BRIEF OF RESPONDENTS

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 20 F.3d 713, and is reproduced in the Appendix to the Petition for a Writ of Certiorari ("Petition") at App. 1-27. The opinion of the United States District Court for the Northern District of Illinois is reported at 812 F. Supp. 845, and is reproduced in the Appendix to the Petition at App. 28-43.

JURISDICTION

The judgment of the court of appeals was entered on March 30, 1994. The Petition was filed on June 28, 1994 and was granted on October 7, 1994. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the following statutes are set forth in the Appendix hereto:

9 U.S.C. § 3
9 U.S.C. § 4
9 U.S.C. § 10(a)(4)

STATEMENT OF THE CASE

In October 1985, petitioners Antonio C. and Diana G. Mastrobuono signed a Client Agreement with Shearson Lehman Hutton Inc. ("Shearson"), a registered broker-dealer now known as Lehman Brothers Inc. (R. 59, ¶ 2 & Ex. A). Paragraph 13 of that Client Agreement specifies that New York law governs, and contains an arbitration provision:

> This agreement . . . shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [petitioners'] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect.

(R. 59, Ex. A).

At the time petitioners executed the Client Agreement and throughout the duration of their account at Shearson, petitioners were residents of Illinois. Antonio Mastrobuono was a college professor and his wife, Diana, was an artist and homemaker. Shearson at all relevant times was a Delaware corporation with its principal place of business in New York. Petitioners conducted their investment transactions at Shearson through Nick DiMinico, a broker employed in Shearson's Houston, Texas branch office. (R. 1, ¶¶ 5-7).

After opening their account at Shearson in October 1985, the petitioners realized trading profits of approximately $125,000 through March 1987. However, after their refusal to meet margin calls precipitated by the October 1987 stock market crash, their remaining investment positions were liquidated, resulting in an alleged out of pocket loss of approximately $65,000. (R. 81, Ex. D, Answer at 8; *see* R. 1, ¶ 59).

On January 30, 1989, petitioners filed an action in the United States District Court for the Northern District of Illinois against Shearson, Nick DiMinico, and others who were subsequently dismissed. (R. 1). Petitioners alleged in that complaint that respondents

had made certain misrepresentations in connection with their investments, that their account had been churned, and that their signatures on the Client Agreement were forgeries thereby negating any obligation to arbitrate their dispute. *(Id.)*.

The complaint alleged claims based upon the Securities Exchange Act of 1934, the Racketeer Influenced and Corrupt Organization Act, the Illinois Securities Law, the Illinois Consumer Fraud and Deceptive Practice Act, breach of contract, breach of fiduciary duty, fraud, misrepresentation and negligence. The Complaint sought for each claim compensatory damages comprised of direct out of pocket losses of $64,184, accountants' fees of $2,000, taxes paid of $20,000 and unspecified interest; treble damages under the RICO claim; and $2,000,000 in punitive damages under the state and common law claims, except the negligence claim. (R. 1 at pp. 19-22). No punitive damages were sought under the federal claims. *(Id.)*.

In April 1989, respondents moved for an order to enforce the Client Agreement's arbitration provision in accordance with its terms pursuant to Sections 3 and 4 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1 *et seq*. (R. 22-23). Discovery ensued with respect to petitioners' allegations that the Client Agreement had been forged. (R. 20). Experts employed by both petitioners and respondents concluded, and the district court found, that the Client Agreement had been signed by both of the petitioners, and the court ordered that the parties proceed to arbitration before

the National Association of Securities Dealers, Inc. ("NASD").[1] (R. 38, 48).

Petitioners filed their Statement of Claim with the NASD on October 20, 1989, making the same claims as in their district court complaint. Thereafter, petitioners filed an Amended Statement of Claim on September 16, 1991, asserting violations of the NASD Rules of Fair Practice, SEC Rule 10b-5, § 15c(1) of the Securities Exchange Act, the Illinois Consumer Fraud Act, the Texas Deceptive Trade Practices Act, and common law claims for breach of fiduciary duty and negligence. (R. 81, Ex. D). Petitioners sought compensatory damages of $199,216 consisting of commissions, mark-ups, other sales charges, and margin interest; treble damages under the Texas Deceptive Trade Practices Act; and punitive damages of $2,000,000. *(Id.*, Ex. D, ¶¶ 16-17).

The arbitration hearings were held before a panel of three arbitrators on August 11 and 12, 1992, and September 29, 1992 in Chicago, Illinois. (R. 59, Ex. D). Respondents submitted a Memorandum Regarding Claim For Punitive Damages to the arbitrators on September 29, 1992, setting forth respondents' position that the New York choice-of-law provision in the Client Agreement precluded the arbitrators from awarding punitive damages. (R. 59, Ex. B). Petitioners submitted a responsive memorandum to the arbitrators on October 6, 1992, contending, *inter alia*, that the arbitrators were not bound to follow either the "letter of the law" or the

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[1] Subsequently, the district court entered sanctions against petitioners of over $3,000 for having made the forgery allegations. (R. 47-48).

"letter of . . . the parties agreement." Their memorandum stated:

> This panel can and should do justice for the parties and apply the rules of law and equity as the arbitrators see them. The panel's decision should reflect the spirit rather than the letter of the law and of the parties agreement.

(R. 59, Ex. C at 2).

On October 13, 1992, the arbitrators issued a written award granting petitioners compensatory damages in the amount of $115,274 in commissions and $44,053 in margin interest, plus $400,000 in punitive damages. (R. 59, Ex. D at 4). The arbitrators' Award stated that their authority for the award of punitive damages was to be found in the above-cited petitioners' memorandum dated October 6, 1992. (*Id.*).

On November 5, 1992, respondents moved the district court for an order vacating the award of punitive damages pursuant to Section 10(a)(4) of the FAA, which permits a court to vacate an award "[w]here the arbitrators exceeded their powers. . . . " 9 U.S.C. § 10(a)(4). (R. 58). The motion was based upon the New York choice-of-law provision in the Client Agreement. On December 11, 1992, petitioners moved the district court for an order confirming the award of punitive damages, or in the alternative, for a trial on the amount of punitive damages to be awarded, or as a further alternative, for a trial on their alleged claims for punitive damages. (R. 68).

The district court vacated the award of punitive damages under 9 U.S.C. § 10(a)(4), finding that punitive damages are not an available remedy where an arbitration agreement is governed by New York law. The court specifically relied on the similar conclusions reached by the Courts of Appeals for the Second and Seventh Circuits. 812 F. Supp. at 847 (citing *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2d Cir. 1991), and *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334, 337-39 (7th Cir. 1984)). The district court further relied upon this Court's decision in *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468 (1989), in concluding that "enforcing an arbitration agreement's choice-of-law provision in accordance with the terms of that agreement is fully consistent with the goals of the FAA." 812 F. Supp. at 847.

The district court also denied petitioners' motion to have the court itself award punitive damages, finding that by operation of the New York choice-of-law provision the petitioners had agreed that the "damages available to them would be those awardable by arbitration under New York law." *Id.* at 848. Furthermore, the court concluded that both Illinois and New York law preclude a separate cause of action solely for punitive damages. *Id.*

The court of appeals affirmed the district court's opinion, concluding in reliance upon *Volt* that the federal policy embodied by the FAA "is simply to ensure the enforceability, *according to their terms*, of private agreements to arbitrate." 20 F.3d at 716 (emphasis in original).

The court of appeals also held: (1) that Illinois law would enforce the New York choice-of-law because there was in fact a relationship between New York

and the parties, *i.e.*, Shearson's principal place of business; and (2) that New York law was not contrary to the public policy of Illinois, which itself recognizes that punitive damages may not be awarded in arbitration unless the parties have expressly agreed to the arbitrator's authority to do so. *Id.* at 719.

The court of appeals also rejected the argument that the district court should have severed the punitive damages claims for trial, finding that under the "plain language of the agreement, the plaintiffs are entitled only to the damages available in arbitration under New York law." *Id.* at 718.

Finally, the court of appeals held that petitioners' argument that a predispute waiver of punitive damages in arbitration is void under the public policies of Texas and Illinois was waived because it had not been raised in the district court. *Id.* at 719.

SUMMARY OF ARGUMENT

This case concerns only the meaning of an arbitration agreement, not whether the agreement is in conflict with or preempted by the FAA or the federal securities laws. The FAA requires federal courts to enforce arbitration agreements according to their terms. That principle was emphatically affirmed by this Court in *Volt*, in which the choice-of-law clause in the arbitration agreement, as construed, required the application of a California statute that ran counter to the otherwise applicable federal law governing stays of arbitration. The Court held that the terms of the arbitration agreement containing the choice-of-law clause prevailed. The Government as *amicus curiae* concedes that the FAA permits an arbitration

agreement to withhold from the arbitrators the power to award punitive damages. The only question is whether the agreement in this case did so.

The issue of contract interpretation turns on the effect to be given to the choice-of-law clause in the Client Agreement involved in this case. The provision specified that New York law should apply. Under New York law, arbitrators have no power to award punitive damages. *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976). Both lower courts in this case held that the choice-of-law clause incorporated the *Garrity* rule. That conclusion is clearly correct, because there is no plausible basis for finding that a choice-of-law provision does not incorporate the chosen state's law concerning remedies as fully as its law concerning the rights and duties of the parties. There is no more reason why the provision needed to make specific reference to the *Garrity* rule than to any other particular rule of New York law, and nothing in the FAA requires giving choice-of-law provisions a different interpretation or effect than they would have if the Act did not apply.

The conclusion required by the choice-of-law clause is consistent with all other provisions of the arbitration agreement at issue, including the provision specifying that the rules of the NASD will govern the arbitration. Nothing in those rules can be construed as giving arbitrators the power to award punitive damages; the NASD rules are silent on the remedial powers of the arbitrators.

It is argued by the Government as *amicus*, but not by petitioners, that § 10(a)(4) of the FAA does not permit a court asked to vacate an award to make its own determination whether the arbitrators "exceeded their powers" but instead requires the court to defer to

the arbitrators' reasonable interpretation of the contract even as to the question of their own power. Even if that were a correct view of § 10(a)(4), it could not be followed in this case because the arbitrators did not interpret the provisions of the contract as giving them power to award punitive damages, but merely based that power on "the spirit rather than the letter of the law and of the parties' agreement." (R. 59, Ex. C at 2).

The narrow view of a court's responsibility under § 10(a)(4) that the Government suggests is at odds with the approach of every court of appeals that has considered the punitive damages issue raised by this case. All of those cases assumed that the *court* should decide the question whether arbitrators "exceeded their powers," rather than defer to the views of the arbitrators. The Government's view would assimilate the question whether arbitrators "exceeded their powers" to every other question of contract interpretation. It would effectively eviscerate § 10(a)(4)'s obvious purpose to treat the "powers" of arbitrators as a distinct issue, to be determined by the court rather than the arbitrators themselves, just as is true with respect to the question whether a particular issue is arbitrable. The courts that have dealt with the question of punitive damages have correctly treated the question as one for the court to decide, and the lower courts in this case were required by § 10(a)(4) to vacate the award upon determining that the arbitration agreement conferred no power on the arbitrators to award punitive damages. But even if courts were required to defer to the arbitrators' "reasonable" views of their own powers, that would not aid the petitioners, since no reasonable interpretation

of the agreement involved in this case would permit the arbitrators to award punitive damages.

The arbitration agreement did not effect a "waiver" of rights to punitive damages. Petitioners' "rights" were only those defined in the agreement itself, as the Court held in *Volt* with respect to a similar argument. Petitioners' argument is in effect an argument that the choice-of-law clause was invalid on the ground of unconscionability. There are no facts in the record to support such a contention. The Court has consistently rejected arguments that clauses in standard commercial contracts are to be disregarded merely because of the alleged unsophistication of one of the parties or their allegedly unequal bargaining power. Petitioners' alternative contention that the district court should have independently tried the issue of punitive damages is equally without merit, for the same reasons and for the additional reason that petitioners are unable to point to any applicable law that creates a "claim" for punitive damages independent of an underlying cause of action for compensatory damages. All of petitioners' "claims" were required to be arbitrated in accordance with the terms of the arbitration agreement.

ARGUMENT

I. THE FEDERAL ARBITRATION ACT REQUIRES ENFORCEMENT OF THE PARTIES' AGREEMENT TO ARBITRATE ACCORDING TO ITS TERMS AND SUCH AN AGREEMENT MAY PRECLUDE AN AWARD OF PUNITIVE DAMAGES.

The only question that this case presents, and the question that is determinative under the FAA, is how the agreement at issue should be construed.

This Court has repeatedly said that the purpose of the FAA is simply to require the enforcement, according to their terms, of arbitration agreements that are within the purview of the Act. *See Volt Info. Sciences, Inc.*, 489 U.S. at 478; *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625-26 (1985). As this Court summarized in *Dean Witter*:

> The legislative history of the Act establishes that the purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate. . . . The Act, after all, does not mandate the arbitration of all claims, but merely the enforcement — upon the motion of one of the parties — of privately negotiated arbitration agreements.
>
> * * *

> [P]assage of the Act was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered, and we must not overlook this principal objective when construing the statute. . . .

470 U.S. at 219-20 (footnote omitted). *See id.* at 220 n.7 (The Act "'creates no new legislation, grants no new rights, except a remedy to enforce an agreement in commercial contracts and in admiralty contracts'" (quoting 65 Cong. Rec. 1931 (1924)); *Volt Info. Sciences, Inc.*, 489 U.S. at 476 ("There is no federal policy favoring arbitration under a certain set of procedural rules: the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.").

A major portion of petitioners' brief is devoted to the argument that "The FAA Preempts State Law Prohibitions Against Arbitral Awards Of Punitive Damages." Pet. Br., Point I, pp. 17-58. The proposition is simply incorrect. Enforcement of the terms of an arbitration agreement that withholds from the arbitrators the power to award punitive damages is entirely consistent with the FAA. Petitioners' argument to the contrary finds no support in any of the numerous cases of this Court discussed in their brief. And there is no basis for finding in the FAA any policy either affirmatively favoring punitive damages or forbidding parties to an arbitration agreement from choosing state law that precludes punitive damages or determines their substantive rights in any other way.

Petitioners cite cases from this Court that identify the strong federal policy favoring arbitration, which requires that state laws must not *interfere* with

the parties' agreement to arbitrate. By contrast, here the agreement *incorporates* the challenged state law, making that law and the agreement one and the same. Ignoring this fundamental difference between the cases they cite and this case, petitioners argue that the FAA requires that arbitration agreements be interpreted to provide an arbitrator with greater authority than the agreement itself supplies. This Court has never held that. None of the cases decided by this Court has held, under the guise of federal preemption, that either party to an arbitration contract shall be entitled to greater rights than they would be entitled to if their agreed choice of law were enforced according to its terms. Such a result is contrary to the express purpose of the FAA.

Since the FAA requires enforcement of the designation of New York law in the parties' agreement, the FAA mandates enforcement, not preemption, of the New York rule of *Garrity v. Lyle Stuart, Inc.*, *supra*, in this case. An issue of preemption under the FAA could arise only if enforcement of state law prevented enforcement of the agreement. *Cf. Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710-11 (7th Cir. 1994); *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir.), *cert. denied*, ___ U.S. ___, 112 S. Ct. 380 (1991), and *cert. denied*, ___ U.S. ___, 112 S. Ct. 1241 (1992). No such issue is present in this case; the state law *is* the agreement.

Contrary to the position asserted by petitioners, the *amicus* brief of the United States and the SEC (hereafter referred to as "SEC Br.") acknowledges that "[s]o far as the FAA is concerned, 'parties are generally free to structure their arbitration agreements as they see fit'" (quoting *Volt*) and may

"limit by contract such matters as the issues they will arbitrate or the rules under which the arbitration will be conducted." SEC Br. 27. The Government's concession is clearly correct.

The controlling effect of the parties' agreement is forcefully illustrated by the decision in *Volt*. Four years before *Volt*, the Court rejected the "intertwining doctrine" and held that the FAA requires immediate arbitration of arbitrable claims notwithstanding the potential impact of such arbitration on the resolution of related but nonarbitrable claims. *Dean Witter Reynolds Inc. v. Byrd*, *supra*. In *Volt*, however, the parties agreed through a choice-of-law clause to incorporate California law in the arbitration agreement, and that was sufficient to override any such requirement of the FAA. The result was to permit a stay of arbitration, pursuant to California law, pending the outcome of related court proceedings (a result probably the equivalent of denying arbitration entirely, since the litigation would in all probability decide the disputed issues). The Court reached that result even though it assumed for purposes of the decision that §§ 3 and 4 of the Act are fully applicable in state court proceedings. *See* 489 U.S. at 476-77. Thus, the agreement of the parties in *Volt*, expressed by a choice-of-law clause, made applicable a state law rule that prevented an arbitration from going forward pursuant to otherwise applicable federal law — an effect more drastic than in this case.

Viewed from this perspective, whether New York's *Garrity* rule is "hostile" to arbitration misses the mark. Rather, enforcing the parties' selection of New York law, with its incorporation of *Garrity*, is the

only way to ensure a result that is compatible with the FAA.

Finally, it is also clear in this case that there is no preemption of state law, and no basis for invalidating the parties' agreement, because of anything in the federal securities laws, which do not even permit the award of punitive damages. *See* 15 U.S.C. § 78bb(a). The SEC suggests that as to customer agreements with broker-dealers entered into after September 7, 1989, the result reached in this case would be changed by Rule 21(f)(4) of the NASD Rules of Fair Practice. SEC Br. 10-12. Whatever the merits of that contention, the issue is not presented here. As the SEC concedes, Rule 21(f)(4) does not apply to the customer agreement in this case, which was executed in 1985; therefore "[t]his case . . . presents a question of contract interpretation, not of preemption by federal securities law." *Id.* at 12.[2]

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[2] Respondents agree with and adopt the arguments of *amicus curiae* Securities Industry Association that Rule 21(f)(4) is not intended to preclude NASD member firms from designating the applicable state law in their customer agreements, even when that state law has the effect of limiting remedies available in arbitration. Respondents also urge the Court to decline the SEC's request for an advisory opinion concerning the effect of Rule 21(f)(4) on customer agreements executed after September 7, 1989. The issue is not relevant to this case, was never raised below and is not urged by petitioners here. The SEC does not claim that the issue has been addressed in the lower courts, and the issue should not be decided in the first instance in this case on the basis of brief argument by an *amicus curiae*. *See United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 60 n.2 (1981); *Bell v. Wolfish*, 441 U.S. 520, 532 n.13 (1979); *Knetsch v. United States*, 364 U.S. 361, 370 (1960).

II. THE ARBITRATION AGREEMENT AT ISSUE WITHHOLDS FROM THE ARBITRATORS THE POWER TO AWARD PUNITIVE DAMAGES.

A. The Choice-Of-Law Clause, By Definition, Includes New York's *Garrity* Rule.

The agreement in this case must be read in a manner consistent with the normal function and meaning of choice-of-law clauses. Nothing in the FAA or in any of this Court's decisions under the Act suggests that there is any federal policy that is hostile to choice-of-law clauses or that justifies selectively excising legal rules that would normally be within the ambit of a choice-of-law clause. To the contrary, this Court's decision in *Volt* shows that the FAA is entirely compatible with choice-of-law clauses and permits giving them comprehensive effect. As the Court said with respect to the arbitration clause in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, there is "no reason to distort the process of contract interpretation" or "color the lens through which the arbitration clause is read" (473 U.S. 614, 627-28 (1985)) in deciding what a choice-of-law clause means.

The function of a choice-of-law clause is to substitute the parties' designation of the applicable law for the choice-of-law rules that a court would apply in the absence of such a choice. The accepted view is that the parties have wide autonomy in making such a designation, and that the law of the chosen state will apply to any issue if the issue "is one which the parties could have resolved by an explicit provision in their agreement directed to that issue."

Restatement (Second) of Conflicts of Laws § 187(1) (Supp. 1988) ("Restatement").

For the reasons already stated, it is beyond dispute that the parties could have withheld from the arbitrators the power to award punitive damages through an explicit prohibition in the agreement. The Government's brief is clear on this point:

> The Act therefore would not prevent the parties from expressly agreeing that punitive damages would not be awardable in any dispute between them, or from accomplishing the same result by inserting explicit contractual language to the effect that resolution of disputes between the parties "will be governed by New York law, including the limitation on arbitral power announced in *Garrity*." (SEC Br. 27.)

Since the issue *is* one that the parties could have resolved by explicit agreement "directed to that issue," the choice-of-law clause accomplishes its normal function by making unnecessary an "explicit provision in their agreement directed to that issue." Otherwise, there would be no need for, and no purpose to be served by, the general designation of "New York law." As the Restatement points out, the rule recognizing choice-of-law agreements rests on the principle of incorporation by reference:

> The rule of this Subsection [§ 187(1)] is a rule providing for incorporation by reference and is not a rule of choice of law. The parties, generally speaking,

> have power to determine the terms of their contractual engagements. They may spell out these terms in the contract. In the alternative, they may incorporate into the contract by reference extrinsic material which may, among other things, be the provisions of some foreign law. In such instances, the forum will apply the applicable provisions of the law of the designated state in order to effectuate the intentions of the parties. So much has never been doubted. (Restatement § 187(1) *Comment c.*)[3]

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[3] There may be issues that the parties are not allowed to resolve by a choice-of-law clause, where the law of a chosen state is contrary to a fundamental policy of a state with a greater interest in the issue. *See* Restatement § 187(2). It is only on that principle that the laws of other states might apply, if they differed from the law of the chosen state. The fact that in this case petitioners "asserted claims based upon Illinois and Texas statutes" says nothing about the intended effect or proper meaning of the choice-of-law clause, as the SEC brief attempts to suggest. SEC Br. 23-24. As the court of appeals found, Illinois, the forum state in this case, clearly has no fundamental policy contrary to New York law with respect to the power of arbitrators to award punitive damages. *See Edward Elec. Co. v. Automation, Inc.*, 229 Ill. App. 3d 89, 104-05, 593 N.E.2d 833, 843, 171 Ill. Dec. 13, 23 (1st Dist.), *app. denied*, 146 Ill. 2d 625, 602 N.E.2d 450, 176 Ill. Dec. 796 (1992) (Punitive damages may not be awarded in arbitration unless "the parties have expressly agreed to the arbitrators' authority to award punitive damages."). 20 F.3d at 719.

As to federal law, it is not the function of choice-of-law clauses to attempt to designate state law in preference to federal law; the rule set forth above, and the well-recognized function of choice-of-law clauses relates to the choice among conflicting and

The principle of incorporation by reference would be useless if, in addition to incorporating by reference, a choice-of-law clause were required to identify specifically each rule of law meant to be adopted by the reference.

There is no requirement that the parties have any specific intention with respect to any rule of the chosen body of law, or even that they be aware of specific rules. It is enough that they have agreed that a designated body of law will be looked to in resolving disputes. To require more would mean that the parties would have to know and have in mind all rules of law that might conceivably apply to any dispute that might arise between them and to make a conscious selection among such rules — an obviously impracticable task. Any such requirement would destroy any reason for having a choice-of-law clause, the very object of which is to enable parties to adopt a *body* of law, rather than specifying detailed rules or being forced to rely on the vagaries of the law applied by whatever court or other forum called upon to decide the dispute or on the uncertainties of conflict-of-law principles applied by such a forum.

After acknowledging that the agreement in this case *could* have incorporated the *Garrity* rule, the *amicus* brief goes on to say: "But the customer agreement here does not expressly say that punitive damages are not allowed, nor does it reference the *Garrity* rule; it says only that New York law governs." (SEC Br. 27).

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potentially applicable rules of *state* law. Federal law always applies, to the extent it bears on the issues.

The question is: Why *should* the choice-of-law clause have "referenced the *Garrity* rule"? And if it should have referenced the *Garrity* rule, why not any and every other rule of New York law that one of the parties seeks to rely on? And if not every other such rule, how is a court supposed to determine which rules of law must be "expressly referenced" to be covered by a choice-of-law clause and which ones need not be? And if a court is to pick and choose what rules must be "expressly referenced," what is the point of a choice-of-law clause in the first place?

To such questions the SEC brief offers no answer. Nor does it cite any authority for the contention that *any* rule of law must be "referenced" expressly to be covered by a choice-of-law clause. The brief merely makes the bald and unsupported statement that: "Standing alone, the choice-of-law provision should not be read to incorporate state law principles that would be preempted if New York law applied of its own force. . . ." *Id.* (footnote omitted).

The brief provides no explanation or support for that pronouncement. The proposition is directly contrary to the decision in *Volt*, notwithstanding the brief's footnote asserting that "[t]his Court's decision in *Volt* is not to the contrary." *Id.* n.18. The very point of the *Volt* decision was that the choice-of-law clause incorporated state law principles that would have been preempted if California law had applied of its own force. The *amicus* brief overlooks the fact that the Court assumed in *Volt* that §§ 3 and 4 of the FAA were fully applicable to state court proceedings; without the choice-of-law agreement, the California procedural rule would clearly have been preempted. *Cf. Dean Witter Reynolds Inc. v. Byrd, supra* (forbidding stay of arbitration of arbitrable claims

which were asserted together with nonarbitrable claims).[4]

The *amicus* brief also overlooks the Court's express statement of its holding in *Volt*:

> We hold that application of the California statute is not pre-empted by the Federal Arbitration Act . . . in a case where the parties have agreed that their arbitration agreement will be governed by the law of California. (489 U.S. at 470).

Apart from all the other objections discussed above, therefore, the Government's suggested "interpretation" of the choice-of-law clause is plainly untenable in the face of the decision in *Volt*.

The holding in *Volt* is not made inapplicable, as the Government's footnote suggests, by the opinion's reference to California's rules for the conduct of arbitration as "manifestly designed to encourage resort to the arbitral process." 489 U.S. at 476. The reference was obviously not to the *particular* California statute at issue — which has the effect of preventing arbitration in the cases to which it applies — but to California's overall scheme for the conduct of arbitration. There is no doubt that New York's rules regarding the conduct of arbitration "encourage resort to the arbitral process" as fully as do those of California. The FAA was modelled on the Arbitration Act of New York, which preceded the enactment of the

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[4] Petitioners' brief reflects the same oversight. It mistakenly argues that *Volt* was decided on the assumption that §§ 3 and 4 of the FAA did not apply to state-court proceedings. Pet. Br. 52.

FAA by approximately five years. *See* S. Rep. No. 536, 68th Cong., 1st Sess. at 3 (1924) (The FAA "follows the lines of the New York arbitration law enacted in 1920. . . .").

The New York Court of Appeals "has repeatedly held that arbitration is a favored method of dispute resolution in New York . . . and New York courts interfere as little as possible with the freedom of consenting parties to submit disputes to arbitration." *Board of Educ. v. Christa Constr., Inc.*, 80 N.Y.2d 1031, 1032, 608 N.E.2d 755, 755, 593 N.Y.S.2d 178, 178 (1992) (mem.) (citations omitted), *modified on other grounds*, 80 N.Y.2d 1033, 608 N.E.2d 756, 593 N.Y.S.2d 179 (1993); *Lipschutz v. Gutwirth*, 304 N.Y. 58, 61, 106 N.E.2d 8, 10 (1952) ("The purpose of [the New York arbitration statute] is to give effect to contracts providing for the settlement of disputes before tribunals of the parties' own choosing by rendering such agreements irrevocable and, in effect, subject to specific enforcement.").

Moreover, it is hard to see how arbitration is encouraged by straining to interpret an arbitration agreement as conferring on the arbitrators power to award punitive damages. The petitioners' position would have the courts bend arbitration agreements in the direction of giving claimants the broadest possible benefits. The utility of arbitration depends on the willingness of parties to submit their disputes to the process. If the judicial approach is to put a thumb on the plaintiff's side of the scale in interpreting the agreement, resort to the process is at least as likely to be deterred as encouraged, especially when the remedy

at issue gives arbitrators an uncontrolled and unreviewable discretion to assess punitive damages.[5]

In any event, it is not evident why the *interpretation* of a choice-of-law provision should be influenced by whether a rule otherwise within the reach of the provision is one that "encourages resort to arbitration" when it is clear, as the *Volt* opinion indicates and the Government concedes, that an "express" adoption of such a rule would be controlling whether or not the rule "encourages arbitration." The opinion in *Volt* had no occasion to face that question, since it accepted the interpretation placed on the choice-of-law clause by the state court. If the normal reading of a choice-of-law clause would result in incorporation, there is no discernible reason why the choice-of-law provision itself should not be the equivalent of an "express" incorporation. *See Baravati*, 28 F.3d at 709 (7th Cir. 1994) (commenting on the cases involving incorporation of the American Arbitration Association rules: "These courts, however, would enforce a provision in an arbitration clause that *forbade* the arbitrator to award punitive damages; and if, as we thought was the situation in *Mastrobuono*, the parties do the same thing by invoking a body of law that contains such a prohibition, there would be

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[5] It is paradoxical that the Government, in sharp contrast to the great deference it urges on the question whether the arbitrators have *power* to award punitive damages (SEC Br. 12-28), is at pains to suggest that § 10(a)(4) of the FAA nevertheless permits judicial review of the *amount* of a punitive damages award. SEC Br. 20 n. 14. The two positions are not easily reconciled. Nor are we aware of any decision where a court, pursuant to § 10(a)(4), has reduced the amount of an arbitral award of punitive damages on the basis that it was excessive.

no greater reason to refuse to honor their choice." (emphasis in original)).

Neither petitioners nor the *amicus* suggests any general principle of contract interpretation that could lead to the conclusion that a choice-of-law clause adopting New York law does not, standing alone, incorporate the *Garrity* rule. (Whether the choice-of-law provision is *contradicted* by other provisions in the agreement is a separate question, which we deal with in detail below. *See* 28-34, *infra*).

In the absence of any limiting provisions, it is fundamental that a choice-of-law clause incorporates not only the liability law of the chosen state, but its law relating to remedies, including whether punitive damages are available. *See, e.g., Moses v. Business Card Express, Inc.*, 929 F.2d 1131, 1139 (6th Cir.), *cert. denied*, ___ U.S. ___, 112 S. Ct. 81 (1991) (choice-of-law clause required application of Michigan rule denying punitive damages notwithstanding parties' relationship to Alabama, whose law permitted such damages); *Power Motive Corp. v. Mannesmann Demag Corp.*, 617 F. Supp. 1048, 1049-50 (D. Colo. 1985) (choice-of-law clause required application of Ohio rule denying punitive damages in contract actions although the law of Colorado, the forum state, would permit such damages); *Kammerer v. Western Gear Corp.*, 96 Wash. 2d 416, 421-23, 635 P.2d 708, 711-12 (1981) (choice-of-law clause adopting California law entitled plaintiff to award of punitive damages although law of Washington, the forum state, would not).

There is no reason to interpret a choice-of-law clause as having a narrower scope than the choice of law that would be dictated by conflict-of-laws principles. Under accepted principles of conflict of laws, the chosen state's law determines the available

remedies. Thus, § 171 of the Restatement provides with respect to torts that damages are to be determined according to the law of the state chosen under the rule of § 145, which is the rule prescribing the law applicable to "the rights and liabilities of the parties." Restatement §§ 145(1), 171 (1971). Similarly, § 207 provides with respect to contracts that the measure of recovery is to be determined by the law of the state that determines the "rights and duties of the parties," *i.e.*, either under Section 188 (which specifies the law applicable in the absence of an effective choice by the parties) or under Section 187 (which is the "law of the state chosen by the parties to govern their contractual rights and duties"). *See, e.g.*, *Rice v. Nova Biomedical Corp.*, 1994 WL 580905 at *7-8 (7th Cir. Oct. 25, 1994) (choosing the law of Illinois, which permits punitive damages, rather than the law of Massachusetts, which does not); *Computer Systems Engineering, Inc. v. Qantel Corp.*, 571 F. Supp. 1365, 1368-70 (D. Mass. 1983), *aff'd*, 740 F.2d 59 (1st Cir. 1984) (choosing the law of Massachusetts rather than the law of California, which permits punitive damages); *Barr v. Interbay Citizens Bank*, 96 Wash. 2d 692, 700, 635 P.2d 441, 445 (1981), *modified on other grounds*, 96 Wash. 2d 692, 649 P.2d 827 (1981).

In short, there is no basis either in logic or in recognized conflict-of-laws principles for grafting onto a choice-of-law clause a distinction between "substance" and "remedy." Remedy *is* substance. Whether the choice-of-law clause is contradicted or limited by some other clause is a different question, as we have already noted. The opinion in *Baravati*, *supra*, explains the decisions of other circuits as reflecting the belief that choice-of-law provisions and provisions incorporating particular arbitration rules

are best "*reconciled*" by confining the choice-of-law provision to substantive matters, allowing arbitrators "free rein in procedural and remedial matters." 28 F.3d at 709 (emphasis added). In the present case, however, as we will show, there is nothing to "reconcile" with the choice-of-law clause and that clause must therefore be given its ordinary effect.

The rule in *Garrity* has been held to be a substantive rule of New York law by federal judges sitting in New York. *See Barbier*, 948 F.2d at 122 (2d Cir. 1991). Those views are entitled to special weight as to what the New York law requires. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 204-05 (1956), and cases cited. *Cf. Hunt v. Bankers & Shippers Ins. Co.*, 73 A.D.2d 797, 798, 423 N.Y.S.2d 718, 720-21 (4th Dep't 1979) (measure of prejudgment interest is substantive under New York state law), *aff'd*, 50 N.Y.2d 938, 409 N.E.2d 928, 431 N.Y.S.2d 454 (1980). State law is controlling as to the interpretation of the choice-of-law clause. *Volt*, *supra*, 489 U.S. at 474 ("Appellant acknowledges, as it must, that the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review."). The relevant state's law is that of New York, because the choice-of-law clause says so.

The petitioners agree with the characterization of the *Garrity* rule as substantive; indeed, they say it is "clearly" substantive. Pet. Br. 56. Inexplicably, they regard the "substantive" nature of the rule as a ground for distinguishing this case from *Volt*. *Id.* The reverse is true: Characterizing the rule as "substantive rather than procedural" makes this an *a fortiori* case for applying *Volt*, because it eliminates any possible ground for treating the rule as outside the scope of the choice-of-law provision. What

petitioners really mean is that *Volt* is wrong; they believe that parties should not be allowed to limit an arbitrator's powers, a position contrary to everything this Court has ever said about the FAA.

B. The Choice-Of-Law Clause Is Entirely Consistent With The NASD Arbitration Rules.

The agreement in this case provides that any controversy arising out of or relating to the customer's accounts or transactions

> shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I [the customer] may elect. If I do not make such election . . . within five days after demand by you that I make such election, then you may make such election.

(R. 59, Ex. A, ¶ 13).

The arbitration in this case was conducted in accordance with the rules of the NASD upon respondents' election after petitioners failed to exercise their right to make an election.[6] The arbitration rules

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[6] It has not been contended by petitioners that the rules of the New York or American Stock Exchanges contain any authority for awarding punitive damages, even if one of those sets

of the NASD are contained in the Code of Arbitration Procedure adopted pursuant to Article VII, Section 1(a)(3) of the Bylaws of the National Association of Securities Dealers. *See* NASD Manual, Code of Arbitration Procedure, Part I, § 1 (CCH) ¶3,701 (1994). The Code has been approved by the SEC as required pursuant to § 19(b)(1) of the Securities Exchange Act. *See* 15 U.S.C. § 78s(b)(1).

The NASD Code of Arbitration Procedure consists of forty-four sections, most of which deal with purely procedural matters. There is no mention of punitive damages. There are only two sections that might be read as bearing on the scope of the arbitrators' powers and neither contains any language that purports to give them any remedial authority not found in the agreement of the parties.

Section 12(a) provides as follows:

> Any dispute, claim, or controversy eligible for submission under Part I of this Code between a customer and a member . . . shall be arbitrated under this Code, *as provided by any duly executed and enforceable written agreement* or upon the demand of the customer. (Emphasis added).[7]

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of rules had been elected.

[7] Contrary to the arguments raised by amicus curiae (AALP Br. 13-15), the petitioners in this instance did not demand arbitration pursuant to Section 12(a). Rather, they steadfastly opposed arbitration and were compelled to such arbitration under a "duly executed and enforceable written agreement."

Far from providing any authority beyond what the arbitration agreement allows, this Section reinforces the limitations of the agreement: it specifies that the agreement governs the arbitration.

Section 41 of the Code deals with awards. Section 41(e) provides as follows:

> The award shall contain the names of the parties, the name of counsel, if any, a summary of the issues, including the type(s) of any security or product in controversy, the damages and other relief requested, the damages and other relief awarded, a statement of any other issues resolved, the names of the arbitrators, the dates the claim was filed and the award rendered, the number and dates of hearing sessions, the location of the hearings, and the signatures of the arbitrators concurring in the award.

There is no language in this Section that could plausibly be read as conferring any remedial powers, and certainly not any powers that are otherwise prohibited by the arbitration agreement.

The district court and the court of appeals were therefore correct in concluding that the incorporation of the NASD rules of procedure did not contradict or limit the arbitration agreement's adoption of New York law. A different panel of the Seventh Circuit has subsequently reached the same conclusion concerning the NASD rules of arbitration procedure. In *Baravati, supra*, the court held that the NASD rules are "silent" on the subject of the arbitrators' powers:

> NASD's Code of Arbitration Procedure, incorporated by reference in the contract between Baravati and JLR, requires arbitrators to provide "a summary of . . . the damages and other relief awarded," but contains no other reference to the arbitrators' remedial powers. (28 F.3d at 709).

Then, after referring to this case (*Mastrobuono*) and other cases dealing with the *Garrity* issue under choice-of-law provisions, the court continued:

> This disagreement does not bear directly on the present case, however, where there is *neither* a choice of law provision *nor a provision in the governing arbitration rules* concerning the scope of the arbitrators' remedial powers. *Id.* (emphasis added).

The same conclusion regarding the meaning of the NASD rules was reached by the California Court of Appeal in *J. Alexander Securities, Inc. v. Mendez*, 17 Cal. App. 4th 1083, 21 Cal. Rptr. 2d 826 (Ct. App. 1993), *cert. denied*, ___ U.S. ___, 114 S. Ct. 2182 (1994), the only other case to consider the effect of the NASD Code of Arbitration Procedure on an arbitration agreement like the one in this case. The court agreed that the NASD Code (as well as the NYSE Rules) was "silent" on the issue of punitive damages. 17 Cal. App.

4th at 1092, 21 Cal. Rptr. 2d at 831. No case appears to have taken a different view of the NASD Code.[8]

Since nothing in the NASD Code of Arbitration Procedure contradicts or impairs the necessary meaning of the choice-of-law clause in the arbitration agreement in this case, there is no basis for finding any ambiguity in the agreement or for resorting to a presumption in favor of a broad interpretation of the arbitrators' powers with respect to punitive damages.[9]

With the single exception of *J. Alexander Securities, Inc. v. Mendez*, discussed *supra*, every one of the cases cited by petitioners as refusing effect to a

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[8] The California court nevertheless refused to give effect to the choice-of-law clause as incorporating the *Garrity* rule, relying at least in part on what it referred to as "the prevailing policy in California." For the reasons set forth in this brief, respondents submit that the decision was erroneous. The court did not discuss *Volt*.

[9] The opinion below also referred to language in the Manual provided to NASD arbitrators stating that "arbitrators can consider punitive damages as a remedy." The court said that it did not think the Manual "authorizes an award of punitive damages in derogation of the governing law of the agreement." 20 F.3d at 717. It is not clear what the court meant, but its conclusion was clearly correct because the arbitrators' Manual is not incorporated in the arbitration agreement. The Manual is not part of the rules of procedure of the NASD and is not even promulgated by the NASD. It is not a set of rules, but merely a compilation of general information for the benefit of arbitrators, compiled by members of SICA (Securities Industry Conference on Arbitration). Many arbitrations before the NASD do not involve agreements that contain choice-of-law provisions. (Among other things, the arbitrators' Manual emphasizes that when an arbitrator's authority is derived from an agreement of the parties, the arbitrator should not exceed that authority.) SICA, The Arbitrator's Manual, at 38 (Cannon I.F.) (May 1992).

choice-of-law provision like the one in this case involved an arbitration agreement that incorporated the American Arbitration Association's Commercial Arbitration Rules ("AAA Rules"). In each of the cases, the decision relied on the existence of AAA Rule 43 as overriding or at least creating a contradiction with the choice-of-law clause.[10] *See Lee v. Chica*, 983 F.2d 883, 887-88 (8th Cir.), *cert. denied*, ___ U.S. ___, 114 S. Ct. 287 (1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062-63 & n.6 (9th Cir. 1991); *Raytheon Co. v. Automated Bus. Sys., Inc.*, 882 F.2d 6, 11-12 n.5 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988); *Willoughby Roofing & Supply v. Kajima Int'l, Inc.*, 598 F. Supp. 353, 358 & n.11 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (per curiam).

The courts relying on AAA Rule 43 focus on the language "any remedy or relief that the arbitrator deems just and equitable" but fail to give effect to the qualifying language, "within the scope of the agreement of the parties. . . ." *See* Tjoflat, J., concurring on other grounds but disagreeing as to the

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[10] In contrast to the NASD Code of Arbitration Procedure, the AAA Rules contain a provision addressing the scope of the arbitrator's remedial powers. The provision is as follows:

> 43. Scope of Award.
>
> The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract.

meaning of AAA Rule 43, *Bonar*, 835 F.2d at 1388-89. Thus, to the extent that the parties have agreed to limit the powers of the arbitrators through a choice-of-law clause, a court should enforce that limitation.[11]

Even if correct on their own facts, however, the conclusions in those cases cannot be applied to this case. Assuming the terms of Rule 43 coupled with a choice-of-law clause provide at least a colorable basis for viewing the arbitration agreement as ambiguous, a presumption in favor of finding power in the arbitrators to award "any remedy or relief" might be appropriate. The same cannot be said in this case, for there is no clause in the NASD rules that defines the powers of the arbitrators and therefore nothing in the arbitration agreement to contradict the necessary meaning of the choice-of-law clause.

III. THE PUNITIVE DAMAGES AWARD EXCEEDED THE ARBITRATORS' POWERS AND WAS THEREFORE PROPERLY VACATED UNDER SECTION 10 OF THE FEDERAL ARBITRATION ACT.

The *amicus* brief of the Government argues that the courts below failed to give proper deference to the arbitrators' construction of the contract and therefore could not properly have concluded that the award "exceeded [the arbitrators'] powers" within the

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[11] *Raytheon* is further distinguishable: (1) The law of California (the state law chosen by the choice-of-law provision) was unclear as to the availability of punitive damages in arbitration, *see* 882 F.2d at 11-12, and (2) the parties stipulated that federal, not state, law applied. *Id.* at 11-12 n.5.

meaning of § 10(a)(4) of the FAA. SEC Br., Point II, 12-28.

That ground for reversal was raised by petitioners in the court of appeals and rejected by that court. 20 F.3d at 716. In this Court, however, the ground has been abandoned by petitioners. It is asserted neither in the Petition for Certiorari nor in petitioners' brief on the merits. *See* Questions Presented, Pet. i, Pet. Br i. We respectfully suggest, therefore, that the issue of the scope of review of the arbitral award is not properly before the Court. *See Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 25 n.2 (1991).

In any event, the argument urged by the *amicus* is not applicable to the facts of this case. The argument assumes that the arbitrators' decision that they had power to award punitive damages was reached by "interpreting the contract." *See* SEC Br. Point II, *passim*. The fact is, however, the arbitrators did not "interpret the contract" for this purpose but instead found it unnecessary to consider the contract's language.

The arbitral award stated:

> Respondents . . . shall pay to Claimants . . . the sum of $400,000.00 in punitive damages. The authority for the Award of punitive damages can be found in Claimants' Response to Shearson's Brief in Opposition to Punitive Damages that had been filed with the NASD on October 6, 1992.

(R. 59, Ex. D, at 4).

Petitioners, in the submission the arbitrators purported to rely upon for the punitive damages award, argued, *inter alia*, that the arbitrators were not required to follow either the "letter of the law" or the "letter of . . . the agreement":

> This panel can and should do justice for the parties and apply the rules of law and equity as the arbitrators see them. *The panel's decision should reflect the spirit rather than the letter* of the law and *of the parties' agreement*.

(R. 59, Ex. C, at 2 (emphasis added)).

Thus, there is no basis in this case for saying or presuming that the arbitrators "interpreted the contract" with respect to the extent of their powers. The arbitrators themselves have revealed that the contrary is true.

The Government's argument rests on the premise that the arbitrators' construction of the agreement is "reasonable" (SEC Br. 19, 25) and reflects an "accommodation" of "ambiguities" in the agreement. *Id.* at 22-25. For the reasons already set forth, there are no inconsistencies or ambiguities in the arbitration agreement here that would support ignoring the *Garrity* rule. Any purported interpretation of the agreement that did so would not have been within the bounds of a fair construction of the agreement. Even accepting the Government's deferential standard of review, therefore, the court would have owed *no* deference to such an interpretation. Thus, this case does not require the Court to "address in detail standards governing the

application of" the requirement of § 10(a)(4) of the FAA that a court vacate an award "[w]here the arbitrators exceeded their powers. . . ." SEC Br. 14.

As the Government's brief indicates, prior decisions of this Court have not had occasion to address § 10(a)(4). SEC Br. 14. Section 10 clearly delineates the specific grounds upon which courts may act to vacate an arbitration award. Congress in § 10(a)(4) expressly provided for judicial vacation of arbitration awards where the arbitrators "exceeded their powers." Thus, the Government's general arguments with respect to the limited number of statutory-mandated bases for vacation of arbitration awards cannot overlook the express grant of judicial authority in § 10(a)(4) to vacate awards where the arbitrators "exceeded their powers." Moreover, there is no suggestion in § 10(a)(4) that a court defer to the arbitrators' own determination of whether they have "exceeded their powers."

What is clear is that § 10(a)(4) requires courts to distinguish between arbitrators' awards that merely "interpret the agreement" and ones that "exceeded their powers," and to exercise their own judgment over whether an award violates the latter limitation. To be sure, every question relating to the powers of an arbitrator is ultimately a question of construction of the arbitration agreement. But the converse is not true: Not every question of construction of the agreement is a question of the arbitrator's "powers." If it were, § 10(a)(4) would have no meaning; it would give courts no more authority when arbitrators "exceeded their powers" than when they act within their powers. The Government's arguments would obliterate the distinction and render § 10(a)(4) meaningless.

For arbitrators to award punitive damages when an arbitration agreement forbids them to do so would seem to be a paradigm of the category to which § 10(a)(4) applies. As the court below said (quoting *Barbier*, 948 F.2d at 122) "[t]here is no clearer case of a case falling . . . within § 10(a)(4)" of the FAA. 20 F.3d at 716. The court below and the Second Circuit are not alone in assuming that the court must decide for itself whether arbitrators have "exceeded their powers" by awarding punitive damages. Regardless of result, the same view appears to have been held by all the other courts of appeals that have considered the question presented by this case, *i.e.*, whether there was power to award punitive damages under an arbitration agreement containing a choice-of-law clause. In none of those cases did the court resolve the question by deferring to the arbitrators' views. *See* cases cited *supra*, 32-33. *See also Humphrey v. Moore*, 375 U.S. 335, 345 n.8 (1964) ("Reconciliation of these two provisions [of the agreement], going to the power of the committee under the contract, itself presented a issue ultimately for the court, not the committee, to decide."); *Cargill Rice, Inc. v. Empresa Nicaraguense Dealimentos Basicos'*, 25 F.3d 223, 226 (4th Cir. 1994) ("[E]ven if the arbitrators here could somehow have interpreted the contract to determine how they should be selected . . . their interpretation would not be entitled to deference because it would have involved a determination of their own jurisdiction." (citations omitted)). To the same effect is the Seventh Circuit's recent decision in *Baravati*, *supra*.

The *Baravati* opinion in particular is illuminating as to the scope of review required by § 10(a)(4). The opinion carefully examined the scope of review of arbitral decisions and adopted a highly

deferential view, rejecting even the "manifest disregard" standard. *See* 28 F.3d at 706. Having done so, the court said: "So it will be enough in this case to consider whether the arbitrators exceeded their powers." *Id*. Then, addressing the question whether the arbitrators had power to award punitive damages, the court interpreted the agreement for itself and did not defer to some supposed interpretation of the contract by the arbitrators.

The Government purports to find some support for its view that the court must defer to the arbitrators' interpretation of their own powers in this Court's decision in *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593 (1960), a labor case that did not refer to or purport to interpret § 10 of the FAA. Any analogy between that case and this one is only superficial. In fact, the case illustrates the distinction between "exceeded [the arbitrators'] powers" and other kinds of contract interpretation.

Whether an arbitrator has any power to grant specific performance, or to order reinstatement of employees, or to award punitive damages is different from the question whether such relief may be awarded under the facts of the particular case. The question in *Enterprise Wheel* was of the latter kind. There was no doubt of the arbitrator's authority in general to award reinstatement and back pay; the only question was whether the contract permitted the back pay to extend beyond the date when the employer theoretically could have discharged the employee as an employee at will. That was a question more aptly called a question of interpretation of the labor contract than a question of

the "powers" of the arbitrator.[12] If § 10(a)(4) of the FAA means anything, it must refer at least to questions of the generic kind, *i.e.*, whether under the agreement the arbitrators have power to award the particular category of relief at all. As to such questions § 10(a)(4) of the FAA can only mean that a court is to decide the issue, just as it must do when the question is whether an issue is subject to arbitration.

This Court has made clear that questions whether the parties have agreed to arbitrate and, if so, what issues are included within that agreement, are for the court to decide, not the arbitrator. *See AT & T Technologies, Inc. v. Communications Workers of America*, 475 U.S. 643, 649 (1986) ("[T]he question of arbitrability . . . is undeniably an issue for judicial determination. Unless the parties *clearly and unmistakably provide otherwise*, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator." (emphasis added)); *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543, 546-47 (1964) ("[N]o doubt" that "[u]nder our decisions, whether or not the company was bound to arbitrate, as well as what issues it must arbitrate is a matter to be determined by the Court on the basis of the contract entered into by the parties."); *Atkinson v.*

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[12] The same is true of the issue dealt with in *W.R. Grace & Co. v. Local Union 759*, 461 U.S. 757 (1983), quoted in a footnote in the Government's brief at page 17. The question in that case was whether a subsequent arbitrator was bound by a prior arbitrator's construction of the collective bargaining agreement. It was not a question whether the arbitrators possessed a particular type of power, but only whether their exercise of their powers was consistent with the collective bargaining agreement.

Sinclair Refining Co., 370 U.S. 238, 241 (1962) (determination of "what issues [a party] must arbitrate is a matter to be determined by the Court on the basis of the contract entered into by the parties."); *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 583 n.7 (1960) (The "question of arbitrability is for the courts to decide. Where the assertion . . . is that the parties excluded from court determination not merely the decision of the merits of the grievance but also the question of its arbitrability, vesting power to make both decisions in the arbitrator, the claimant must bear the burden of a clear demonstration of that purpose." (citation omitted)).

This Court also has stated with regard to labor arbitrations that: "The willingness of parties to enter into agreements that provide for arbitration of specified disputes would be 'drastically reduced,' however, if a labor arbitrator had the 'power to determine his own jurisdiction. . . .'" *AT & T Technologies, Inc.*, 475 U.S. at 651 (quoting Cox, Reflections Upon Labor Arbitration, 72 Harv. L. Rev. 1482, 1509 (1959)). That principle also is applicable to commercial arbitrations.

The Government's brief concedes, as we have previously discussed, that the parties could have "expressly" agreed that the choice-of-law clause included New York's *Garrity* rule. In such a case could the Government plausibly urge that it was within the power of the arbitrators to "interpret the agreement" and, therefore, a court could not vacate the award? The answer must surely be "No." Yet, as we have shown, the choice-of-law clause must be treated exactly as if it did "expressly" incorporate the *Garrity* rule, and nothing in the agreement is to the contrary.

If a court would ever be required to vacate such an award, it is required to do so in this case.

IV. THE AGREEMENT BETWEEN THE PARTIES ESTABLISHES THEIR RIGHTS AND BARS PETITIONERS FROM SEEKING PUNITIVE DAMAGES IN A SEPARATE COURT PROCEEDING.

Petitioners argue that the arbitration agreement, if construed as excluding punitive damages, improperly required petitioners to "waive" their "right" to punitive damages. Pet. Br. 58-69. In other words, petitioners argue the agreement is invalid and unenforceable if it precludes punitive damages.

The argument is without merit. A similar argument was made and was rejected by the Court in *Volt*, 489 U.S. at 474-75. There the plaintiff's argument was that the court's construction of the choice-of-law clause was in effect a finding that the plaintiff had "waived" its federal right to compel arbitration. This Court said it was not a finding of "waiver" at all but a finding that the plaintiff had no such "right" in the first place, because the agreement did not require arbitration to proceed under the circumstances of the case. The same is true here. There is no waiver of any "right" because petitioners' rights are defined by the agreement, unless the agreement is invalid or is overridden by some affirmative requirement of law.

Petitioners' argument is even weaker than the one made in *Volt* because there the plaintiff had at least a colorable basis for arguing that its alleged "right" was conferred by the FAA. But here

petitioners cannot credibly claim that the FAA or any other federal statute or policy gives them a right to punitive damages. There is not the slightest basis for saying that the FAA favors punitive damages. Nor is there any other federal statute applicable in this case that could be the source of such a right; the fact is that all of the express and implied private rights of action under the Securities Act and the Exchange Act -- the principal bodies of federal law which govern the securities markets -- preclude the award of punitive damages. 15 U.S.C. §§ 77l, 78bb(a). *See, e.g., Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1283-87 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Thus, Congress has never deemed it necessary for "investor protection" to confer upon investors any "right" to seek punitive damages under applicable federal law.[13]

If the alleged "right" to punitive damages is not conferred by federal law, what is its supposed source?[14] Petitioners do not say. They obviously do not mean New York law, because New York law under the circumstances of this case provides that there is *no* right to punitive damages. If the right is supposedly

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[13] Although investors may not seek punitive damages under the federal securities laws, the securities industry is governed by a myriad of federal and state agencies, and self-regulatory organizations, including but not limited to the SEC, the Securities Divisions of all fifty states, the New York Stock Exchange, the American Stock Exchange, and the NASD, all of which have the power to fine, suspend, and expel brokerage firms and their employees.

[14] State law is the only logical choice because there are no federal claims that allow for the recovery of punitive damages in this case.

conferred by some other state, what state — any state whose law happens to favor the petitioners' position?

Petitioners are in effect attacking choice-of-law clauses. They claim that respondents caused them to sign an agreement with a choice-of-law clause that, with respect to a particular issue, has turned out to be unfavorable to them. The argument is unrelated to the fact that the *Garrity* rule applies to arbitrators, not courts. If the choice-of-law clause adopted the law of, say, Washington or Nebraska, states that do not allow punitive damages at all, petitioners' argument would be the same. Their position is that a choice-of-law clause cannot be used to effect a "waiver" of any arguably applicable rule that happens to favor the plaintiffs. Their brief is explicit on the point:

> The usefulness of this "waiver by implication" precedent does not end with just punitive damages. One can hypothecate [sic] any number of similar issues which choice-of-law provisions may obviate, depending on the state of choice, thereby increasing the prejudice to investors and the degree to which the deck can be stacked against them. (Pet. Br. 66-67).

The Court could not accept petitioners' "waiver" argument without completely undermining the utility of choice-of-law clauses in contracts covered by the Federal Arbitration Act. Choice-of-law clauses obviously have "salutary effects" of the same general nature as those referred to by the Court in upholding the forum-selection clause involved in *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593-94 (1991). In

that case the Court said: "[W]e do not adopt the Court of Appeals' determination that a nonnegotiated forum-selection clause in a form ticket contract is never enforceable simply because it is not the subject of bargaining." *Id.* at 593. The Court has also recently said:

> Mere inequality in bargaining power, however, is not a sufficient reason to hold that arbitration agreements are never enforceable in the employment context. Relationships between securities dealers and investors, for example, may involve unequal bargaining power, but we nevertheless held in *Rodriguez de Quijas* and *McMahon* that agreements to arbitrate in that context are enforceable.

Gilmer, 500 U.S. at 33 (citations omitted).

Petitioners' argument is essentially that the Court should decline to enforce the arbitration agreement, or the choice-of-law clause it contains, on grounds of unconscionability. Other objections to the argument to one side, the contention is one that was not made or considered below and there is no factual record to support it. That in itself is a sufficient ground for rejecting it. *See, e.g., DeShaney v. Winnebago County DSS*, 489 U.S. 189, 195 n. 2 (1989); *Duignan v. United States*, 274 U.S. 195, 200 (1927).[15]

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[15] Petitioners would have the Court believe that investors are helpless and have no choice but to accept an arbitration agreement of the kind involved in this case. The facts are otherwise. The SEC has specifically considered that question and

Finally, the lower courts properly denied petitioners' alternative request to separately seek punitive damages in court. As both lower courts properly found, under the plain language of the agreement petitioners were entitled only to the relief available in arbitration under New York law. 20 F.3d at 718; 812 F. Supp. at 848. Moreover, as the district court found, neither Illinois nor New York law permits a separate cause of action for punitive damages. 812 F. Supp. at 848. *See also Kemner v. Monsanto Co.*, 217 Ill. App. 3d 188, 199, 576 N.E.2d 1146, 1153, 160 Ill. Dec. 192, 199 (5th Dist.), *app. denied*, 142 Ill. 2d 655, 584 N.E.2d 130, 164 Ill. Dec. 918 (1991); *McGrew v. Heinold Commodities, Inc.*, 147 Ill. App. 3d 104, 110, 497 N.E.2d 424, 429, 100 Ill. Dec. 446, 451 (1st Dist. 1986); *Florsheim v. Travelers Indem. Co.*, 75 Ill. App. 3d 298, 309-10, 393 N.E.2d 1223, 1233, 30 Ill. Dec. 876, 886 (1st Dist. 1979); *Bishop v. Bostick*, 141 A.D.2d 487, 489, 529 N.Y.S.2d 116, 118 (2d Dep't 1988); *Santos v. Security & Law Enforcement Employees, Council 82*, 80 A.D.2d 554, 554, 435 N.Y.S.2d 357, 358 (2d Dep't 1981).

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concluded as follows: "[T]he Commission is reluctant to dictate the terms of a fully disclosed agreement between a broker-dealer and a customer. Investors currently have access to basic brokerage services without agreeing to pursue any future disputes through arbitration, rather than through the courts. This is so because a number of broker-dealers, including several large full-service broker-dealers in the country, do not require the signing of account agreements for cash accounts." Order Approving Proposed Rule Changes by the NYSE, NASD and the AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, SEC Rel. No. 34-26805, 54 Fed. Reg. 21,144, 21,154 (1989) (footnote omitted).

CONCLUSION

For all the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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APPENDIX

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9 U.S.C. § 3 provides:

Stay of proceedings where issue therein referable to arbitration.

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 4 provides, in relevant part:

Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. . . .

9 U.S.C. § 10(a)(4) provides:

Same; vacation; grounds; rehearing.

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration --

* * *

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.